

**ARIZONA HEALTH CARE
COST CONTAINMENT SYSTEM**

**FINANCIAL STATEMENTS
AND ADDITIONAL INFORMATION**

Year Ended June 30, 2004

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MANAGEMENT'S DISCUSSION AND ANALYSIS

MANAGEMENT'S DISCUSSION AND ANALYSIS

Management of the Arizona Health Care Cost Containment System ("AHCCCS" or the "Agency") provides this Management's Discussion and Analysis for the benefit of the readers of the AHCCCS financial statements. This narrative overview and analysis of the financial activities of AHCCCS is for the fiscal year ended June 30, 2004. We encourage readers to consider this information in conjunction with the basic financial statements and related footnotes that follow this section.

Financial Highlights

Government-Wide:

Net Assets - The assets of AHCCCS exceeded its liabilities at fiscal year ended June 30, 2004 by \$11.1 million (presented as "net assets"). Approximately \$6.6 million of the total net assets at June 30, 2004 is unrestricted and represents the amount available to meet AHCCCS' ongoing general obligations to members and creditors. The remaining net assets at June 30, 2004 are comprised of the net amount invested in capital assets of \$4.5 million.

Changes in Net Assets - AHCCCS' total net assets decreased for the second consecutive year. The fiscal year 2004 decrease is \$15.3 million (a 57.8 percent decrease in total net assets) compared to the \$66.4 million (71.6 percent) decrease in total net assets that occurred in fiscal year 2003. The key factor for the decrease in net assets in fiscal year 2004 is a change in business policy where the available unrestricted net assets of \$11.4 million were used to the extent available to offset the accrual for incurred but not reported (IBNR) programmatic claims. Prior policy accrued a receivable from the State of Arizona ("State") rather than use the available unrestricted net assets. The carry-forward balance in the Tobacco Tax and Health Care Fund - Medically Needy Account, funded the majority of the IBNR accrual. Also contributing to the decrease in net assets was the termination of the Premium Sharing Program in fiscal year 2004.

Fund Level:

Governmental Funds - Fund Balances - As of the close of fiscal year 2004, AHCCCS' total governmental funds reported an ending fund balance of \$4.4 million, a decrease of \$14.3 million (a 76.6 percent decrease) in comparison with the prior fiscal year. As previously discussed, the fiscal year 2003 carry-forward for the Tobacco Tax and Health Care Fund - Medically Needy Account of \$13.4 million was reduced by \$11.6 million in fiscal 2004 through expenditures authorized by the legislature. This represents 81.0 percent of the decrease in the fund balance.

Proprietary Fund - Fund Balance - The proprietary fund reported net assets of \$3.0 million at June 30, 2004. In fiscal year 2004, the proprietary fund incurred a net operating loss of \$2.7 million. This loss was offset by a \$3 million transfer in from the General Fund to subsidize the proprietary fund operations. As a result, the net assets increased by \$0.3 million.

Overview of the Financial Statements

This discussion and analysis is intended to serve as an introduction to AHCCCS' basic financial statements, which are comprised of three components: 1) government-wide financial statements, 2) fund financial statements and 3) notes to the financial statements.

Government-Wide Financial Statements

The Government-Wide Financial Statements are designed to provide readers with a broad overview of AHCCCS' finances that is comparable to a private-sector business. The Statement of Net Assets and the Statement of Activities are two financial statements that report information about AHCCCS, as a whole, and about its activities. The presentation in these statements is intended to help answer the question: is AHCCCS, as a whole, better off or worse off financially as a result of this year's activities? These

financial statements are prepared using the flow of economic resources measurement focus and the full accrual basis of accounting. They take into account all revenues and expenses connected with the fiscal year even if cash involved has not been received or paid.

The Statement of Net Assets presents information on all of AHCCCS' assets and liabilities, with the difference between the two reported as "net assets". Over time, increases or decreases in net assets, along with other financial information, serve as indicators of AHCCCS' financial position and whether it is improving or deteriorating.

The Statement of Activities presents information showing how AHCCCS' net assets changed during the most recent fiscal year. All changes in net assets are reported as soon as the underlying events giving rise to the change occur, regardless of the timing of related cash flows. Therefore, revenues and expenses are reported in this statement for some items that will result in cash flows in future fiscal periods (e.g. incurred but not reported fee-for-service and reinsurance claims, revenue for future Tobacco Master Settlement Agreement payments, and earned but unused vacation leave).

Both statements report two categories:

- **Governmental Activities** - The activities in this category are primarily supported by the State appropriations and federal and county intergovernmental revenues. The governmental activities of AHCCCS are specific to programs authorized by the Social Security Act Titles XIX Medicaid and XXI State Children's Health Insurance Program (SCHIP) that are concentrated on the health needs of the citizens of Arizona. Most all of AHCCCS' activities are reported in this category.
- **Business-Type Activities** - This category is comprised of the Healthcare Group operations. Members/customers of Healthcare Group are charged a premium for the health care coverage provided. The State also subsidizes a portion of this program with an appropriation from the General Fund.

The government-wide financial statements can be found on pages 13 and 14.

Fund Financial Statements

A fund is a fiscal and accounting entity with a self-balancing set of accounts that AHCCCS uses to keep track of specific sources of funding and spending for specific activities or objectives. AHCCCS, like other State agencies, uses fund accounting to ensure and demonstrate compliance with legislative appropriation funding requirements. All of the funds of AHCCCS can be divided into two categories: governmental funds and the proprietary fund.

Governmental funds - Governmental funds are used to account for essentially the same functions reported as governmental activities in the government-wide financial statements. However, unlike the government-wide financial statements, the governmental funds financial statements focus on near-term inflows and outflows of spendable resources, as well as on balances of spendable resources available at the end of the fiscal year. Such information may be useful in evaluating a government's near-term financial position and requirements. This approach is known as using the flow of current financial resources measurement focus and the modified accrual basis of accounting. These financial statements provide a short-term view of AHCCCS' finances that assists management in determining whether there will be adequate financial resources available to meet current needs.

Because the focus of governmental funds is narrower than that of the government-wide financial statements, it is useful to compare the information presented for governmental funds with similar information presented for governmental activities in the government-wide financial statements. By doing so, readers may better understand the long-term impact of the State's near-term financial decisions. Both the governmental fund balance sheet and the governmental fund statement of revenues, expenditures and changes in fund balances provide a reconciliation to facilitate this comparison between governmental funds and governmental activities. The basic governmental funds financial statements and related reconciliations can be found on pages 15 through 17 of this report.

AHCCCS reports two fund categories: General Fund and Other Fund. Information on these funds is presented separately in the governmental fund balance sheet and in the governmental fund statement of revenues, expenditures and changes in fund balances. In prior years, the Tobacco Tax and Health Care Fund - Medically Needy Account was reported as a Major Fund. However, in fiscal 2004, this fund no longer meets the criteria to qualify as a Major Fund and is now combined into the single, aggregated presentation under Other Governmental Funds.

The Legislature adopts an appropriated budget for AHCCCS for the acute care, (includes separate line item appropriations for Acute Care Base and Proposition 204 populations), long-term care programs and for program administration. The annual appropriation is made separately for both the State matching funds and federal financial participation funds from Social Security Act Titles XIX (Medicaid) and XXI (State Children's Health Insurance Program). A budgetary comparison statement has been provided for the General Fund to demonstrate compliance with the budget.

Proprietary fund - This fund is used to account for activities that charge customers for the services provided. Proprietary funds are prepared using the flow of economic resources measurement focus and the full accrual basis of accounting; the same method used by private sector businesses. There is no reconciliation needed between the government-wide financial statements for business-type activities and the proprietary fund financial statements.

AHCCCS maintains one proprietary fund that is classified as an enterprise fund. AHCCCS uses this fund to account for the program that provides health insurance coverage for qualifying business organizations including some State political subdivisions. The basic proprietary fund financial statements can be found on pages 19 through 21 of this report.

Notes to the Financial Statements

The notes to the financial statements provide additional information that is essential to a full understanding of the data provided in the government-wide and fund financial statements. The notes to the financial statements can be found on pages 22 to 36.

Government-Wide Financial Analysis

As noted earlier, net assets may serve over time as a useful indicator of a government agency's financial position.

AHCCCS Net Assets (in thousands of dollars)

	Governmental Activities		Business-type Activities		Total	
	2004	2003	2004	2003	2004	2003
Current assets	\$ 317,330	\$ 375,016	\$ 8,026	\$ 9,461	\$ 325,356	\$ 384,477
Capital assets	5,955	3,709	220	7	6,175	3,716
Total assets	<u>323,285</u>	<u>378,725</u>	<u>8,246</u>	<u>9,468</u>	<u>331,531</u>	<u>388,193</u>
Current liabilities	313,818	355,096	5,197	6,719	319,015	361,815
Noncurrent liabilities	1,389	-	-	-	1,389	-
Total liabilities	<u>315,207</u>	<u>355,096</u>	<u>5,197</u>	<u>6,719</u>	<u>320,404</u>	<u>361,815</u>
Net assets:						
Invested in capital assets, net of related debt	4,256	3,709	220	7	4,476	3,716
Unrestricted	<u>3,822</u>	<u>19,920</u>	<u>2,829</u>	<u>2,742</u>	<u>6,651</u>	<u>22,662</u>
Total net assets	<u>\$ 8,078</u>	<u>\$ 23,629</u>	<u>\$ 3,049</u>	<u>\$ 2,749</u>	<u>\$ 11,127</u>	<u>\$ 26,378</u>

In the case of AHCCCS, assets exceeded liabilities by \$11.1 million and \$26.4 million at June 30, 2004 and 2003, respectively.

The largest portion of AHCCCS' unrestricted net assets consists of cash available at the close of the fiscal year and the investment in capital assets, less the related outstanding debt used to acquire those assets. That portion of the net assets at June 30, 2004 representing cash (39.2 percent) is available to pay for both administrative and programmatic expenditures in the next fiscal year. The balances available for administrative expenditures are limited in general to funding various information technologies and third party liability recovery effort costs that follow the legislative intent of the specific fund. Programmatic expenditures can be funded from the balance in the Tobacco Tax and Health Care Fund - Medically Needy Account for both the Proposition 204 and Acute care programs. AHCCCS uses its capital assets to provide services to citizens and consequently, these assets are not available for future spending.

AHCCCS Changes in Net Assets
(in thousands of dollars)

	Governmental Activities		Business-type Activities		Total	
	2004	2003	2004	2003	2004	2003
Revenues						
Program revenues						
Charges for Services	\$ 5,418	\$ 5,090	\$ 30,602	\$ 26,283	\$ 36,020	\$ 31,373
Other Operating						
Grants and						
Contributions	377,681	380,674	-	-	377,681	380,674
Federal Operating						
Grants	3,671,335	3,122,325	-	-	3,671,335	3,122,325
General revenues						
State appropriations	970,649	857,803	-	-	970,649	857,803
Tobacco tax	194,171	138,450	-	-	194,171	138,450
Unrestricted interest						
income	759	1,558	146	116	905	1,674
Total revenues	5,220,013	4,505,900	30,748	26,399	5,250,761	4,532,299
Expenses						
Health Care	5,204,025	4,543,192	33,437	31,790	5,237,462	4,574,982
Excess (deficiency)						
before transfers	15,988	(37,292)	(2,689)	(5,391)	13,299	(42,683)
Transfers	(31,539)	(29,647)	2,989	5,945	(28,550)	(23,702)
Increase (decrease)						
in net assets	(15,551)	(66,939)	300	554	(15,251)	(66,385)
Net assets - beginning	23,629	90,568	2,749	2,195	26,378	92,763
Net assets - ending	\$ 8,078	\$ 23,629	\$ 3,049	\$ 2,749	\$ 11,127	\$ 26,378

At June 30, 2004 and 2003, AHCCCS reported positive balances in net assets for the Agency as a whole, as well as for its separate governmental and business-type activities.

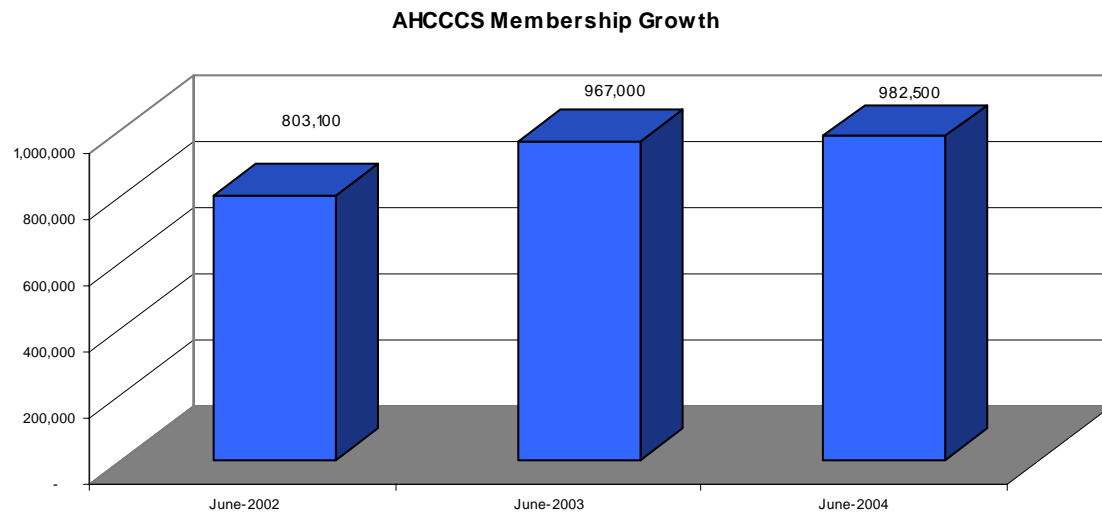
There was a \$300,000 increase in net assets reported in connection with AHCCCS' business-type activity in fiscal year 2004. The increase resulted primarily from a \$2.989 million subsidy from the general fund. During the year, the subsidy was used for reinsurance and administrative costs. The reinsurance costs will expend a total of \$2.9 million including the final projected payment accrued for on the statement of net assets – proprietary fund. The subsidy is reported as a transfer in on the statement of revenues, expenses and changes in fund net assets – proprietary fund. The general fund subsidy is \$4 million for fiscal year 2005. The increase is also due partly to an increase in the premium rate charged to participating employers effective March 1, 2004. The rate increase was intended to build a stabilization reserve to offset any negative impact on the health care organizations caused by the introduction of new products.

AHCCCS' governmental net assets decreased by \$15.6 million during the current fiscal year. In addition to the previously discussed change in business policy where the available unrestricted net assets of \$11.4 million were used to the extent available to offset the due from State government made for IBNR programmatic claims funded by a carry-forward balance in the Tobacco Tax and Health Care Fund - Medically Needy Account, the Legislature ended the Premium Sharing program and the final reinsurance payments utilized the Fund's carry-forward balance. Payments from these two funds accounted for the decrease in the governmental activities' net assets.

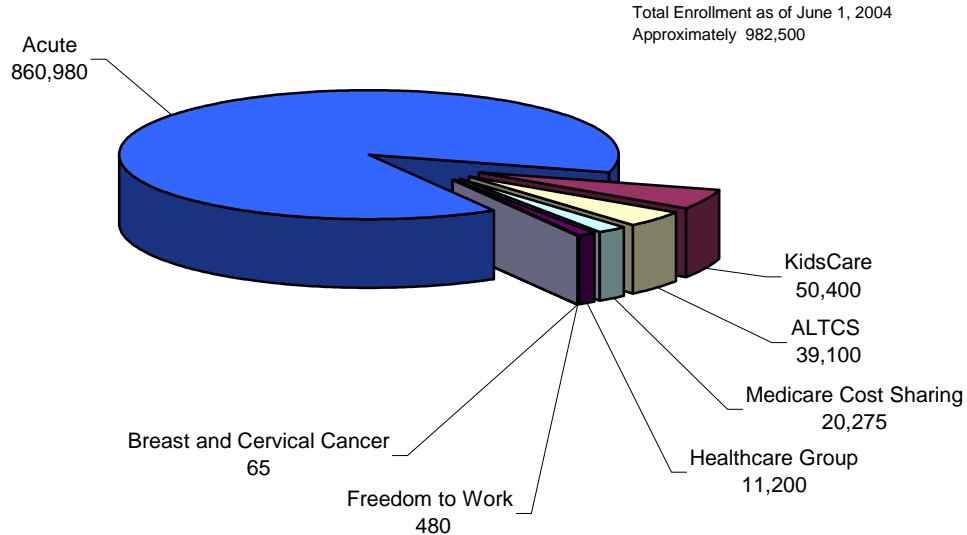
Governmental Activities

Governmental activities decreased AHCCCS' net assets by \$15.6 million during fiscal 2004 accounting for the entire decrease in the net assets of AHCCCS. Key elements of this decrease were the change in business policy to fund payments for the estimate for IBNR programmatic claims from available unrestricted balances and the close out of the Premium Sharing Program. The overall program enrollment growth that had been the main contributing factor to the growth in program expenditures subsided during the fiscal year 2004. The overall population reached a high of 997,500 as of September 1, 2003. Since March 1, 2001, just prior to the implementation of Proposition 204, the overall program population has increased by 396,000 members to 982,500 as of June 1, 2004, a 67.5 percent growth rate. Of this amount, 124,100 (31.0 percent of the total 67.5 percent growth rate) are members who were made eligible by Proposition 204 since the March 1, 2001 effective date. From June 1, 2003 to June 1, 2004, the AHCCCS program population increased 15,500 (1.6 percent).

The following charts depict AHCCCS membership growth and enrollment by program for the reporting period:



AHCCCS Enrollment by Program

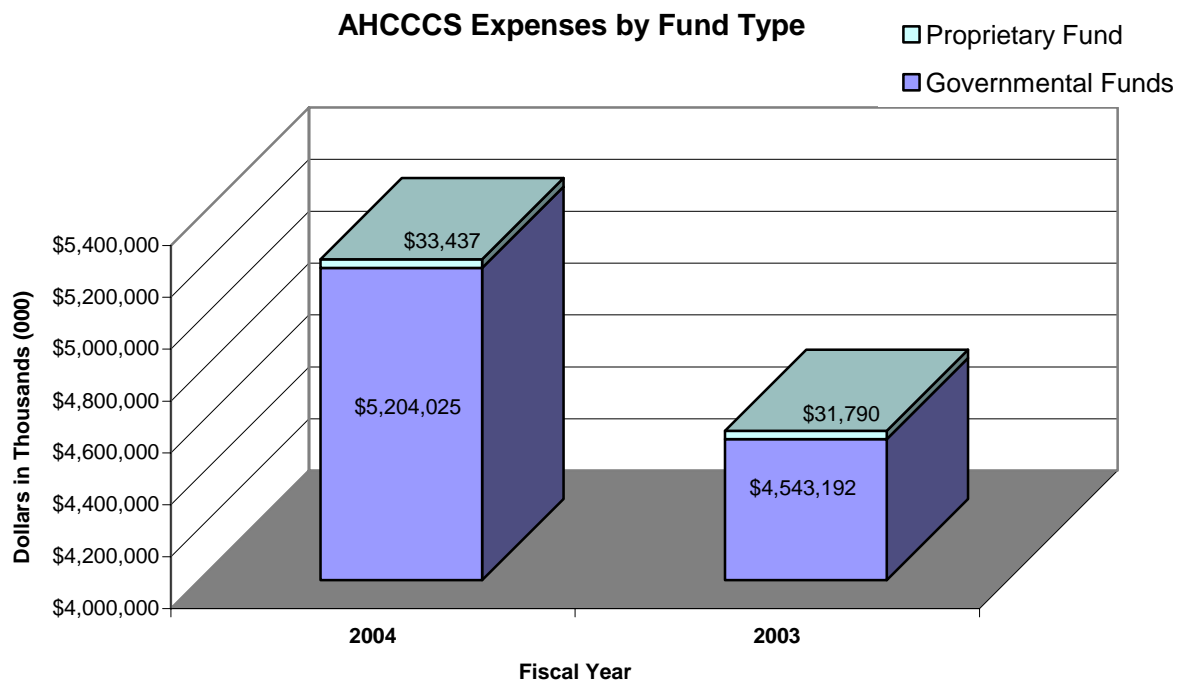
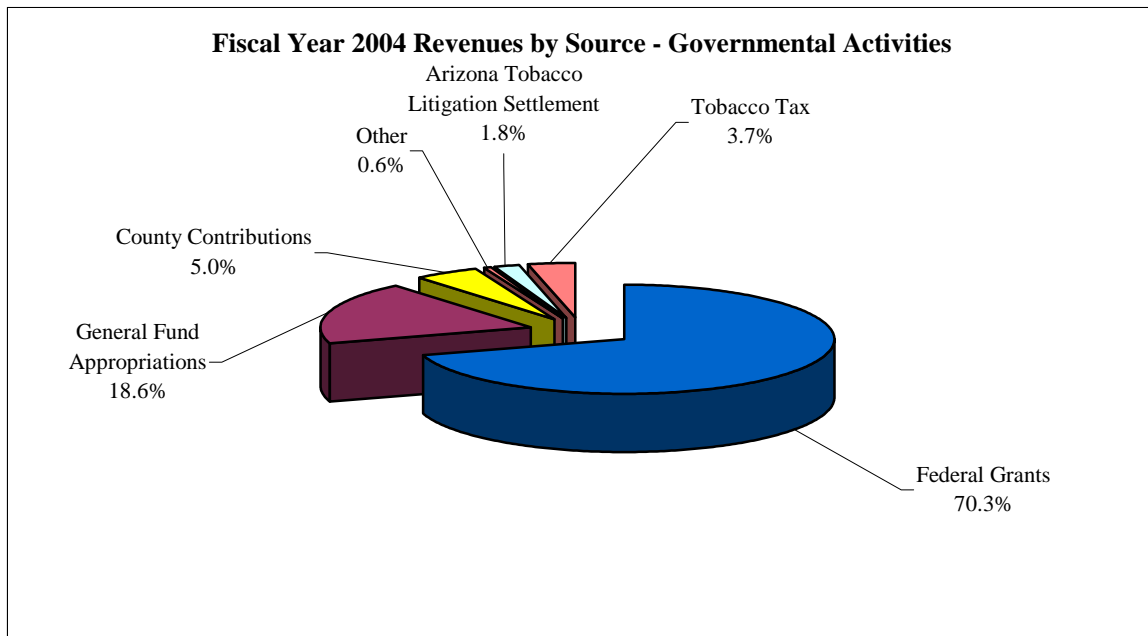


The cost of health care programs, including Title XIX Medicaid and Title XXI SCHIP, totaled \$5,204.0 million in fiscal 2004, a \$660.8 million increase over the \$4,543.2 million reported in fiscal year 2003. As shown in the statement of activities, the amount of expenditures funded from federal grants through the Centers for Medicare and Medicaid Services (CMS) was \$3,671.3 million (70.5 percent) in fiscal 2004 and \$3,122.3 million (68.7 percent) in fiscal 2003. Funding in the form of federal financial participation is primarily determined through the Federal Medical Assistance Percentages (FMAP) used to provide the amount of federal matching for State medical assistance expenditures. The FMAP or federal share of program costs is based on the relationship between Arizona's per capita personal income and the national average per capita personal income over three calendar years. The FMAP is recalculated each year and increased by .01 percent to 67.26 percent from the prior year's 67.25 percent rate. However, the Jobs and Growth Tax Relief Reconciliation Act of 2003 (P.L. 108-27) Subsection 401(a) provided a 2.95 percent temporary increase in the FMAP for all but certain expenditures that increased the actual reimbursement rate for the final three quarters of the fiscal year to 70.21 percent. The temporary increase provided an additional \$153.5 million in grant revenue for the fiscal year ended June 30, 2004.

State, county and miscellaneous funding sources combined to provide \$1,548.7 million in State funding sources and appropriations in fiscal year 2004, a \$165.1 million increase over the \$1,383.6 million reported in fiscal year 2003. State General Fund revenues raised primarily in the form of sales and income taxes directed to AHCCCS amounted to \$690.4 million and an additional \$280.3 million was passed through from other State agencies in order to provide the State's share for Title XIX Medicaid and Title XXI SCHIP eligible medical assistance expenditures. Arizona counties contributed \$260.4 million as determined by Session Law. An additional \$91.6 million in State revenue funding was provided by the annual payments awarded to AHCCCS as administrator of the Tobacco Litigation Settlement Funds awarded to Arizona.

In April 2004, the Governmental Accounting Standards Board (GASB) issued GASB Technical Bulletin No. 2004-1, *Tobacco Settlement Recognition and Financial Reporting Entity Issues*, to clarify recognition guidance for the payments made to AHCCCS pursuant to the Master Settlement Agreement (MSA) with the major tobacco companies. Payments are based on cigarette sales from the preceding year. In accordance with GASB Technical Bulletin No. 2004-1, AHCCCS has accrued \$44.8 million for the period through June 30, 2004 based on revised national payment estimates adjusted for historical payment trends. Prior to the issuance of GASB Technical Bulletin No. 2004-1, AHCCCS recognized the revenue related to these payments as they were received.

The following charts depict revenues by source of the governmental activities for the fiscal year and expenses for the reporting period:



Business-Type Activities

The sole business-type activity for AHCCCS is the Healthcare Group (HCG). The HCG administers a prepaid medical coverage program for small businesses with 1 to 50 employees and employees of political subdivisions. HCG is intended to be self-funded by charging a premium to participating employers that covers both the costs of providing medical services and administrative costs of operating

the program. However, the program has been incurring operating losses for the past several years and has required a subsidy from the State to cover those operating losses. In fiscal year 2004, HCG was supported by a \$2.989 million subsidy from the General Fund. In fiscal 2003, this subsidy was \$5 million. The use of subsidy dollars is reflected as an Interfund Transfer in the Government-Wide Statement of Activities.

HCG's projected final reinsurance expenses for the 2004 plan year are \$779,000. This amount results in a decrease of \$2.013 million from the \$2.792 million in reinsurance expense in fiscal year 2003. The reduction in this expense resulted in a reduction in the subsidy requirement. New emphasis on the medical management aspect of the program is expected to further reduce reinsurance costs and the need for future subsidies. Additionally, premiums were increased by an average of 3.8 percent effective March 1, 2004 in order to build a stabilization reserve to offset any negative impact to the health care organizations to support the introduction of new products. The fiscal year 2005 subsidy is \$4 million and will be available to offset any negative impact to the health care organizations as new products are introduced. As previously noted, the business-type activity increased AHCCCS' net assets by \$300,000, after the \$2.989 million subsidy described above. This increase is primarily due to the effort to build the stabilization reserve funds through the premium increase. Implementation of HCG's marketing plan is reversing the declining enrollment trend from prior years. Enrollment remained relatively steady at 11,200, with a 1.8 percent decline from the previous fiscal years' enrollment of 11,400. This is an improvement from the 7.6 percent decline in the previous year. Enrollment since March 2004 has increased to 11,170.

Financial Analysis of AHCCCS' Governmental Funds

Governmental Funds

At the end of fiscal year 2004, AHCCCS' governmental funds reported combined ending fund balances totaling \$4.369 million, a decrease of \$14.283 million from the prior year balance. As previously discussed, the change in business policy to fund payments for the estimate made for IBNR programmatic claims from available unrestricted balances that utilized the carry-forward balance in the Tobacco Tax and Health Care Fund - Medically Needy Account, the termination of the Premium Sharing Program and the final reinsurance payments utilized the carry-forward balances that were available to fund operations.

The General Fund is the chief operating fund of the AHCCCS Acute Care, Proposition 204 and Long-Term Care programs. These programs utilize a State general fund appropriation and revenue sources from the annual tobacco litigation settlement proceeds as well as taxes on tobacco products.

The Other Governmental Funds consist of six individual funds that have a combined total fund balance of \$4.369 million available to meet future year obligations. In fiscal year 2004, the Tobacco Tax and Health Care Fund – Medically Needy Account that was previously classified as the only AHCCCS Major Fund is now combined into the single, aggregated presentation under Other Governmental Funds. This Fund's previous classification was based on its unrestricted fund balance. The continued utilization of carry-forward balances reduced the fund balance to a level that no longer requires classification as a Major Fund. The Other Governmental Fund's fiscal year-end available cash balance is \$1.831 million and represents 41.9 percent of the total governmental fund's unrestricted fund balance. Revenue from taxes on cigarettes and other related tobacco products generated \$135.7 million for the current year and accounts for 85.6 percent of the total Other Governmental Funds revenues. The remaining \$2.538 million consists of balances in the Third Party Liability Fund and the Hawaii Arizona PMMIS Alliance Fund and are available for administrative expenditures limited to funding various information technologies and third party liability recovery effort costs.

General Fund Budgetary Highlights

Differences occurred between the original and the final amended administrative and programmatic expenditure budgets (\$22.312 million). The key factor that contributed to this difference was a supplemental appropriation that increased the federal expenditure authority for the Disproportionate Share Hospital (DSH) special line item by \$21.1 million in conjunction with federal legislation that increased the federal DSH Allotment for Arizona by 16 percent. AHCCCS additionally was required to

transfer in appropriations to provide the required state matching funds of \$6.86 million. There were also minor increases authorized by legislation totaling \$226,700 to offset increased employer health insurance and retirement contributions. All other differences relate to special line item adjustments that utilized surpluses from one source to offset shortfalls in another line item. These appropriation transfers are approved by the Governor's Office of Strategic Planning and Budgeting and are in accordance with legislative authority. The major special line item revisions can be briefly summarized as follows:

- \$55.993 million increase to capitation payments
- \$5.500 million increase to Proposition 204 – services
- \$7.739 million increase to Medicare payments
- \$39.517 million decrease to the fee-for-service payments
- \$33.722 million decrease to reinsurance payments

At fiscal year-end, actual cash basis expenditures were \$78,859 million less than budgetary estimates, thus providing carry-forward balances that are available to be used for administrative adjustments as authorized by State statute.

Capital Asset Administration

AHCCCS' investment in capital assets for its governmental and business-type activities as of June 30, 2004 amounts to \$6.175 million, net of accumulated depreciation. This investment in capital assets includes furniture, vehicles and equipment. Land, buildings and improvements are under the management of the State and are accounted for on the State's comprehensive annual financial report. The major capital asset addition for fiscal year 2004 was acquired through a combination of cash and a capital lease purchase agreement and was for telecommunication equipment that replaced aging, at-risk telephone equipment with voice over internet protocol technology. Additional purchases include the normal planned retirement and replacement of automated systems and related equipment and vehicles. The total increase in AHCCCS' investment in capital assets for the current fiscal year was 66.2 percent or \$2.459 million.

AHCCCS Capital Assets
(net of depreciation, in thousands of dollars)

	Governmental Activities		Business-type Activities		Total	
	2004	2003	2004	2003	2004	2003
Vehicles	\$ 557	\$ 918	\$ -	\$ -	\$ 557	\$ 918
Furniture and equipment	5,398	2,791	220	7	5,618	2,798
Total net assets	<u>\$ 5,955</u>	<u>\$ 3,709</u>	<u>\$ 220</u>	<u>\$ 7</u>	<u>\$ 6,175</u>	<u>\$ 3,716</u>

Additional information on AHCCCS' capital assets and lease obligation can be found in Notes 2 and 3 to the accompanying financial statements on page 28.

Long-Term Contingent Liability

In January 2001, AHCCCS obtained a Section 1115 Waiver ("Waiver") from CMS to receive federal funding for certain non-categorically linked populations including those made eligible by the November 2000 passage of Proposition 204 by the citizens of Arizona. The Waiver requires that over the term of the agreement, April 1, 2001 through September 30, 2006, the population covered by the Waiver be budget neutral for CMS. Budget neutral means that CMS will not pay more for medical services with the Waiver than it would without it. The Waiver Special Terms and Conditions (STC) include a monitoring arrangement that requires AHCCCS to report the financial results of the Waiver on a quarterly basis. It also established a diminishing annual threshold of the amount that AHCCCS is able to exceed the Budget Neutrality limit on an interim basis before being required to submit a corrective action plan. The reporting limit threshold for the second Budget Neutrality period, which ended September 30, 2003, was 3 percent. At June 30, 2004 AHCCCS is below the limit by \$7.0 million (0.15 percent) on a cumulative basis. The

third Budget Neutrality period does not end until September 30, 2004. Through June 30, 2004, AHCCCS remains under the cumulative reporting limit threshold.

During the current fiscal year, enrollment growth decreased with annual overall enrollment growth of less than 2.0 percent. In fiscal year 2003, enrollment growth was 20.0 percent. Total enrollment at June 30, 2004 was 982,500 as compared to 967,000 at June 30, 2003. Projections prepared as part of the AHCCCS fiscal year 2006 budget request, indicate that the Waiver will be budget neutral through September 30, 2006. However, it is important to note that the calculation of budget neutrality is comprised of many components and is very volatile. These include: estimating the number of new members due to Proposition 204, the economy and its impact on unemployment, medical inflation and policy decisions that impact program costs made by the Arizona Legislature.

Economic Factors and Next Years Budgets and Rates

AHCCCS continues to experience growth in its various membership populations. AHCCCS enrollment appeared to stabilize early in fiscal year 2004 after two years of extraordinary growth. Since the high of 997,500 as of September 1, 2003 enrollment decreased or remained flat through May 2004, to 941,600. However, enrollment has increased over 64,400 members back up to 1,006,000 as of September 1, 2004. The brief period of decline may be attributed to a legislative change in the re-determination periods from twelve to six months and an increase in the number of pending initial applications at the eligibility determination agency. The re-determination period was returned to twelve months in the past legislative session and the number of pending applications has begun to be reduced and the number of new applicants has increased; therefore, AHCCCS expects enrollment to continue to grow, but at a lower rate than experienced during the first few months of fiscal year 2005.

AHCCCS capitation rates are required to be actuarially sound. Utilization and inflationary trends for health care costs are incorporated in the rate development process. The primary drivers for rate inflation continue to be increases in utilization and costs for pharmacy (37 percent of rate increase), physician costs (21 percent), and transportation and inpatient costs (14 percent). The contract year 2005 capitation ranges resulted in a weighted average increase of 5.7 percent. This increase factors in a reduction for hospital outpatient reimbursement as mandated by recently passed legislation.

The AHCCCS program that provides medical coverage for parents of KidsCare and SOBRA eligible children whose adjusted net countable income is between 100% and 200% of the Federal poverty level is scheduled for repeal as of June 30, 2005. A significant benefit of this program allows AHCCCS to use SCHIP (Title XXI) federal allotments for the Childless Adult populations within Proposition 204. This benefit is projected to save \$17.4 million in State funded expenditures in fiscal year 2005 from the enhanced SCHIP FMAP (77.22 percent versus 67.45 percent) and a savings of \$120 million in expenditures against the federal budget neutrality limit which are subsequently not charged against Title XIX.

All of these factors were considered in preparing the AHCCCS' budget for fiscal year 2005. The possibility exists that AHCCCS will require a supplemental appropriation in fiscal year 2005 based on early fiscal year 2005 enrollment growth. The use of fiscal year 2004 reversion dollars could reduce the amount needed in a supplemental appropriation, if any.

Request for Information

This financial report is designed to provide a general overview of AHCCCS' finances for the State's citizens, taxpayers and AHCCCS' members, providers and creditors. Questions concerning any of the information provided in this report or requests for additional financial information should be addressed to the Arizona Health Care Cost Containment System, Division of Business and Finance, Attention: Finance Administrator MD 5400, 701 East Jefferson, Phoenix, Arizona 85034.

INDEPENDENT AUDITORS' REPORT



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INDEPENDENT AUDITORS' REPORT

To the Director of the

ARIZONA HEALTH CARE COST CONTAINMENT SYSTEM

(AHCCCS, an agency of the state of Arizona)

We have audited the accompanying financial statements of the governmental activities, the business-type activities and the aggregate remaining fund information of **AHCCCS** at and for the year ended June 30, 2004, as shown on pages 13 through 21. These financial statements and the schedule referred to below are the responsibility of **AHCCCS'** management. Our responsibility is to express an opinion on these financial statements and the schedule based on our audit.

We conducted our audit in accordance with U.S. generally accepted auditing standards and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

As discussed in Note 1, the financial statements of **AHCCCS** are intended to present the financial position, the changes in financial position and cash flows, where applicable, of only that portion of the governmental activities, the business-type activities and the aggregate remaining fund information of the state of Arizona that are attributable to the transactions of **AHCCCS**. They do not purport to, and do not, present fairly the financial position of the state of Arizona at June 30, 2004, and the changes in its financial position and its cash flows, where applicable, for the year then ended in conformity with U.S. generally accepted accounting principles.

In our opinion, the financial statements referred to above present fairly, in all material respects, the respective financial position of the governmental activities, the business-type activities and the aggregate remaining fund information of **AHCCCS** at June 30, 2004, and the respective changes in financial position and cash flows, where applicable thereof, and the respective budgetary comparison for the general fund for the year then ended in conformity with U.S. generally accepted accounting principles.

The accompanying management's discussion and analysis on pages 1 through 10 and the budgetary comparison information on page 18 is not a required part of the basic financial statements but is supplementary information required by the Governmental Accounting Standards Board (GASB). We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the required supplementary information. However, we did not audit the information and express no opinion on it.

Our audit was conducted for the purpose of forming an opinion on the financial statements that collectively comprise **AHCCCS'** basic financial statements. The accompanying Schedule of Expenditures of Federal Awards is presented for purposes of additional analysis as required by the U.S. Office of Management and Budget Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*, and is not a required part of the basic financial statements. This schedule has been subjected to the auditing

procedures applied in the audit of the basic financial statements and, in our opinion, is fairly stated in all material respects in relation to the basic financial statements taken as a whole.

In accordance with *Government Auditing Standards*, we have also issued our report dated November 12, 2004 on our consideration of **AHCCCS'** internal control over financial reporting and our tests of its compliance with certain provisions of laws, regulations, contracts, and grants. That report is an integral part of an audit performed in accordance with *Government Auditing Standards*, and should be read in conjunction with this report in considering the results of our audit.

This report is intended solely for the information and use of **AHCCCS** and the state of Arizona Auditor General and is not intended to be and should not be used by anyone other than these specified parties.

Mayer Hoffman McCann P.C.

Phoenix, Arizona
November 12, 2004

BASIC FINANCIAL STATEMENTS

ARIZONA HEALTH CARE COST CONTAINMENT SYSTEM

STATEMENT OF NET ASSETS

June 30, 2004

(amounts expressed in thousands)

ASSETS

	Governmental Activities	Business-type Activities	Total
CURRENT ASSETS			
Cash	\$ 73,105	\$ 7,718	\$ 80,823
Restricted cash	11,281	-	11,281
Due from state and county governments	16,554	-	16,554
Due from the federal government	171,500	-	171,500
Tobacco settlement receivable	44,862	-	44,862
Internal balances	(300)	300	-
Receivables and other	328	8	336
TOTAL CURRENT ASSETS	317,330	8,026	325,356
CAPITAL ASSETS			
Furniture, vehicles and equipment, net of accumulated depreciation	5,955	220	6,175
TOTAL ASSETS	323,285	8,246	331,531

LIABILITIES

CURRENT LIABILITIES			
Accounts payable	23,651	56	23,707
Other accrued liabilities	2,899	49	2,948
Bank overdraft	4,945	-	4,945
Deferred revenue	17,530	4,247	21,777
Due to federal, state and county governments	36,124	-	36,124
Accrued programmatic costs	225,593	779	226,372
Current portion of compensated absences	2,766	66	2,832
Current portion of capital lease obligation	310	-	310
TOTAL CURRENT LIABILITIES	313,818	5,197	319,015
CAPITAL LEASE OBLIGATION, less current portion	1,389	-	1,389

COMMITMENTS AND CONTINGENCIES

NET ASSETS

INVESTED IN CAPITAL ASSETS, NET OF RELATED DEBT	4,256	220	4,476
UNRESTRICTED	3,822	2,829	6,651
TOTAL NET ASSETS	\$ 8,078	\$ 3,049	\$ 11,127

See Notes to Financial Statements

ARIZONA HEALTH CARE COST CONTAINMENT SYSTEM

STATEMENT OF ACTIVITIES

Year Ended June 30, 2004
(amounts expressed in thousands)

	Program Revenues				Net (Expense) Revenue and Changes in Net Assets		
	Program Expenses	Charges for Services	Federal Operating Grants	Other Operating Grants and Contributions	Governmental Activities	Business-type Activities	Total
PROGRAMS							
Government activities:							
Health care programs	\$ 5,204,025	\$ 5,418	\$ 3,671,335	\$ 377,681	\$ (1,149,591)	\$ -	\$ (1,149,591)
Business-type activities:							
Healthcare Group	33,437	30,602	-	-	-	(2,835)	(2,835)
TOTAL PROGRAMS	<u>\$ 5,237,462</u>	<u>\$ 36,020</u>	<u>\$ 3,671,335</u>	<u>\$ 377,681</u>	<u>(1,149,591)</u>	<u>(2,835)</u>	<u>(1,152,426)</u>
General revenues:							
State appropriations					970,649	-	970,649
Tobacco tax					194,171	-	194,171
Unrestricted investment earnings					<u>759</u>	<u>146</u>	<u>905</u>
					1,165,579	146	1,165,725
Transfers:							
Transfers in					430	-	430
Transfers out					(28,980)	-	(28,980)
Interfund transfers					<u>(2,989)</u>	<u>2,989</u>	<u>-</u>
Total general revenues and transfers					<u>1,134,040</u>	<u>3,135</u>	<u>1,137,175</u>
CHANGE IN NET ASSETS					(15,551)	300	(15,251)
NET ASSETS, BEGINNING OF YEAR					<u>23,629</u>	<u>2,749</u>	<u>26,378</u>
NET ASSETS, END OF YEAR					<u>\$ 8,078</u>	<u>\$ 3,049</u>	<u>\$ 11,127</u>

See Notes to Financial Statements

ARIZONA HEALTH CARE COST CONTAINMENT SYSTEM

BALANCE SHEET - GOVERNMENTAL FUNDS

June 30, 2004
(amounts expressed in thousands)

	General Fund	Other Governmental Funds	Total Governmental Funds
<u>ASSETS</u>			
Cash	\$ 58,213	\$ 14,892	\$ 73,105
Restricted cash	11,107	174	11,281
Due from state and county governments	3,931	13,559	17,490
Due from the federal government	59,357	-	59,357
Due from other funds	11,416	-	11,416
Receivables and other	328	-	328
	<hr/>	<hr/>	<hr/>
TOTAL ASSETS	\$ 144,352	\$ 28,625	\$ 172,977
	<hr/>	<hr/>	<hr/>
<u>LIABILITIES</u>			
Accounts payable	\$ 21,096	\$ 2,555	\$ 23,651
Other accrued liabilities	2,490	409	2,899
Bank overdraft	4,945	-	4,945
Deferred revenue	17,400	130	17,530
Due to federal, state and county governments	35,403	174	35,577
Due to other funds	300	11,416	11,716
Accrued programmatic costs	62,718	9,572	72,290
	<hr/>	<hr/>	<hr/>
TOTAL LIABILITIES	144,352	24,256	168,608
	<hr/>	<hr/>	<hr/>
COMMITMENTS AND CONTINGENCIES			
<u>FUND BALANCES</u>			
Unreserved	<hr/> -	<hr/> 4,369	<hr/> 4,369
TOTAL FUND BALANCES	<hr/> -	<hr/> 4,369	<hr/> 4,369
	<hr/>	<hr/>	<hr/>
TOTAL LIABILITIES AND FUND BALANCES	<u>\$ 144,352</u>	<u>\$ 28,625</u>	

Amounts reported for governmental activities in the statement of net assets are different because:

Capital assets used in governmental activities are not financial resources and, therefore, are not reported in the funds.	\$ 5,955
Governmental funds report capital outlays as expenditures. However, in the statement of activities the cost of these assets is allocated over their estimated useful lives and reported as depreciation expense. This is the amount by which capital outlays (\$2,151) exceeded depreciation (\$1,604) in the current fiscal year.	(547)
Long-term liabilities for capital lease obligations are not due and payable in the current fiscal year and, therefore, are not reported in the funds.	(1,699)
Long-term liabilities for accrued paid time off are not due and payable in the current fiscal year and, therefore, are not reported in the funds.	(2,766)
Long-term receivables, offsetting the above accrued paid time off liability, which are not receivable in the current fiscal year and, therefore, are not reported in the funds.	2,766
Accrued liabilities for programmatic costs are not due and payable from current financial resources and, therefore are not reported in the funds.	(153,304)
Long-term receivables, offsetting the above accrued programmatic liability, which is not due and receivable in the current fiscal year and, therefore, are not reported in the funds.	<hr/> 153,304
NET ASSETS OF GOVERNMENTAL ACTIVITIES	<u>\$ 8,078</u>

See Notes to Financial Statements

ARIZONA HEALTH CARE COST CONTAINMENT SYSTEM

STATEMENT OF REVENUES, EXPENDITURES AND CHANGES IN FUND BALANCES - GOVERNMENTAL FUNDS

Year Ended June 30, 2004
(amounts expressed in thousands)

	General Fund	Other Governmental Funds	Total Governmental Funds
REVENUES			
State government:			
Appropriations	\$ 693,579	\$ -	\$ 693,579
Pass through funds	280,296	-	280,296
Federal government:			
Acute care	2,218,166	1,113	2,219,279
Long-term care	523,555	-	523,555
Pass through funds	818,649	-	818,649
County government:			
Acute care	73,192	-	73,192
Long-term care	181,916	-	181,916
Pass through funds	5,325	-	5,325
Tobacco litigation settlement revenue	46,738	-	46,738
Tobacco tax revenue	58,471	135,700	194,171
Gaming revenue	-	12,616	12,616
Intergovernmental agreement revenue	-	7,781	7,781
Premium revenue	5,174	-	5,174
Other	5,018	1,237	6,255
TOTAL REVENUES	<u>4,910,079</u>	<u>158,447</u>	<u>5,068,526</u>
PROGRAMMATIC EXPENDITURES			
Capitation:			
Acute care	2,184,462	62,370	2,246,832
Long-term care	1,205,677	-	1,205,677
Children's Rehabilitative Services	45,746	-	45,746
Mental health services	594,021	-	594,021
Fee-for-service:			
Acute care	393,150	10,124	403,274
Long-term care	62,566	-	62,566
Trauma center services	-	15,631	15,631
Disproportionate share	157,940	-	157,940
Graduate medical education	20,477	-	20,477
Reinsurance	18,891	3,300	22,191
Medicare premiums:			
Acute care	58,389	-	58,389
Long-term care	19,078	-	19,078
Payments to counties	4,825	-	4,825
TOTAL PROGRAMMATIC EXPENDITURES	<u>4,765,222</u>	<u>91,425</u>	<u>4,856,647</u>
ADMINISTRATIVE EXPENDITURES	167,461	8,792	176,253
ADMINISTRATIVE EXPENDITURES PASSED THROUGH	21,663	-	21,663
TOTAL EXPENDITURES	<u>4,954,346</u>	<u>100,217</u>	<u>5,054,563</u>
EXCESS (DEFICIENCY) OF REVENUES OVER (UNDER) EXPENDITURES	<u>(44,267)</u>	<u>58,230</u>	<u>13,963</u>
OTHER FINANCING SOURCES (USES)			
Transfers out:			
To AHCCCS General Fund	-	(43,565)	(43,565)
To AHCCCS Other Funds	(32)	-	(32)
To Arizona Department of Health Services	-	(28,100)	(28,100)
To Arizona Department of Health Services Health Crisis Fund	-	(880)	(880)
To Healthcare Group	(2,989)	-	(2,989)
Transfers in:			
From Tobacco Products Tax Fund - Emergency Health Services Account	22,989	-	22,989
From Medically Needy Account	20,576	-	20,576
From State General Fund	-	32	32
From Arizona Department of Health Services Health Crisis Fund	430	-	430
Capital lease obligation	3,293	-	3,293
TOTAL OTHER FINANCING SOURCES (USES)	<u>44,267</u>	<u>(72,513)</u>	<u>(28,246)</u>
NET CHANGE IN FUND BALANCES	-	(14,283)	(14,283)
FUND BALANCES, BEGINNING OF YEAR	-	18,652	18,652
FUND BALANCES, END OF YEAR	<u>\$ -</u>	<u>\$ 4,369</u>	<u>\$ 4,369</u>

See Notes to Financial Statements

ARIZONA HEALTH CARE COST CONTAINMENT SYSTEM

RECONCILIATION OF THE STATEMENT OF REVENUES, EXPENDITURES AND CHANGES IN FUND BALANCES OF GOVERNMENTAL FUNDS TO THE STATEMENT OF ACTIVITIES

Year Ended June 30, 2004
(amounts expressed in thousands)

Amounts reported for governmental activities in the statement of activities (page 14) are different because:

Net change in fund balance - total governmental funds (page 16)	\$ (14,283)
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Governmental funds report capital outlays as expenditures. However, in the statement of activities the cost of those assets is allocated over their estimated useful lives and reported as depreciation expense. Due to its pass through nature, AHCCCS accrues revenue sufficient to eliminate its deficit fund balance and, therefore, this is the amount by which capital outlays exceeded depreciation in the prior period.

<u>(1,268)</u>

Change in net assets of governmental activities (page 14)	<u>\$ (15,551)</u>
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ARIZONA HEALTH CARE COST CONTAINMENT SYSTEM

BUDGETARY COMPARISON SCHEDULE - GENERAL FUND

Year Ended June 30, 2004
(Unaudited)
(amounts expressed in thousands)

	Original Appropriation (Budget)	Final Appropriation (Budget)	Actual	Variance with Final Budget
REVENUES				
State appropriations	\$ -	\$ -	\$ 699,716	\$ -
State pass-through funds	-	-	306,684	-
Federal government	-	-	2,864,149	-
Federal pass-through funds	-	-	817,128	-
County government	-	-	262,955	-
County pass-through funds	-	-	4,826	-
Tobacco tax revenue	-	-	58,434	-
Tobacco litigation settlement	-	-	92,550	-
Other	-	-	10,356	-
Total revenues	-	-	5,116,798	-
OTHER FINANCING SOURCES				
Operating transfers in	-	-	297,214	-
TOTAL REVENUES AND OTHER FINANCING SOURCES	-	-	5,414,012	-
PROGRAMMATIC EXPENDITURES				
Acute capitation	1,284,314	1,340,307	1,340,065	242
Acute fee-for-service	359,105	319,588	312,085	7,503
Proposition 204 services	918,871	924,371	912,478	11,893
Reinsurance	79,002	45,281	40,581	4,700
Medicare premiums	38,883	46,622	45,396	1,226
Graduate medical education	20,477	20,477	20,477	-
Disproportionate share	136,867	164,825	153,929	10,896
Breast and cervical cancer	2,647	2,170	807	1,363
Critical access hospitals	1,700	1,700	1,700	-
Freedom to work	2,903	2,727	2,141	586
County hold harmless	4,826	4,826	4,826	-
Long-term care	825,405	825,404	793,694	31,710
CHIP - Services	66,438	70,288	70,288	-
CHIP - Parents	38,197	33,047	29,995	3,052
TOTAL PROGRAMMATIC EXPENDITURES	3,779,635	3,801,633	3,728,462	73,171
ADMINISTRATIVE EXPENDITURES	162,855	163,169	157,481	5,688
OPERATING TRANSFERS OUT	-	-	14,515	(14,515)
TOTAL APPROPRIATED EXPENDITURES	3,942,490	3,964,802	3,900,458	64,344
PRIOR YEAR APPROPRIATED EXPENDITURES	-	-	85,202	-
NON-APPROPRIATED EXPENDITURES	-	-	1,405,533	-
REVENUES AND OTHER FINANCING SOURCES OVER (UNDER) EXPENDITURES	-	-	22,819	-
FUND BALANCES, BEGINNING OF YEAR	-	-	25,405	-
FUND BALANCES, END OF YEAR	\$ -	\$ -	\$ 48,224	\$ -

See Notes to Financial Statements

ARIZONA HEALTH CARE COST CONTAINMENT SYSTEM

STATEMENT OF NET ASSETS - PROPRIETARY FUND

June 30, 2004
(amounts expressed in thousands)

ASSETS

CURRENT ASSETS

Cash	\$	7,718
Receivables and other		<u>308</u>
TOTAL CURRENT ASSETS		8,026

CAPITAL ASSETS

Furniture, vehicles and equipment, net of accumulated depreciation		<u>220</u>
TOTAL ASSETS	\$	<u>8,246</u>

LIABILITIES

CURRENT LIABILITIES

Accounts payable	\$	56
Other accrued liabilities		49
Deferred revenue		4,247
Accrued programmatic costs		779
Compensated absences due within one year		<u>66</u>

TOTAL CURRENT LIABILITIES	\$	<u>5,197</u>
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COMMITMENTS AND CONTINGENCIES

NET ASSETS

INVESTED IN CAPITAL ASSETS	\$	220
UNRESTRICTED		<u>2,829</u>
TOTAL NET ASSETS	\$	<u>3,049</u>

ARIZONA HEALTH CARE COST CONTAINMENT SYSTEM

STATEMENT OF REVENUES, EXPENSES AND CHANGES IN FUND NET ASSETS - PROPRIETARY FUND

Year Ended June 30, 2004
(amounts expressed in thousands)

OPERATING REVENUES	
Premium revenue	<u>\$ 30,602</u>
OPERATING EXPENSES	
Premiums paid to health plans	30,501
Reinsurance	1,192
Salaries and employee benefits	1,022
Professional and outside services	270
Other	446
Depreciation	<u>6</u>
TOTAL OPERATING EXPENSES	<u>33,437</u>
OPERATING LOSS	(2,835)
NONOPERATING REVENUE (primarily investment income)	<u>146</u>
LOSS BEFORE TRANSFERS	(2,689)
TRANSFERS IN	
From General Fund	<u>2,989</u>
CHANGE IN NET ASSETS	300
NET ASSETS, BEGINNING OF YEAR	<u>2,749</u>
NET ASSETS, END OF YEAR	<u><u>\$ 3,049</u></u>

See Notes to Financial Statements

ARIZONA HEALTH CARE COST CONTAINMENT SYSTEM

STATEMENT OF CASH FLOWS - PROPRIETARY FUND

Year Ended June 30, 2004
(amounts expressed in thousands)

CASH FLOWS FROM OPERATING ACTIVITIES

Receipts from customers	\$ 30,969
Payments to health plans	(33,705)
Payments to employees	(977)
Payments to suppliers	<u>(641)</u>
Net cash used in operating activities	<u>(4,354)</u>

CASH FLOWS FROM NONCAPITAL FINANCING ACTIVITIES

Operating subsidies from other funds	<u>1,504</u>
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CASH FLOWS FROM INVESTING ACTIVITIES

Increase in restricted cash	3,332
Interest	146
Payments for capital assets	<u>(220)</u>
Net cash provided by investing activities	<u>3,258</u>

NET CHANGE IN CASH	408
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CASH, BEGINNING OF YEAR	<u>7,310</u>
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CASH, END OF YEAR	<u>\$ 7,718</u>
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RECONCILIATION OF OPERATING LOSS TO NET CASH USED IN OPERATING ACTIVITIES

Operating loss	\$ (2,835)
Adjustment to reconcile operating loss to net cash used in operating activities:	
Depreciation	6
Changes in operating net assets and liabilities:	
Increase in receivables and other	(3)
Increase in accounts payable and other accruals	78
Increase in deferred revenue	369
Decrease in accrued programmatic costs	(2,013)
Increase in accrued compensated absences	<u>44</u>
NET CASH USED IN OPERATING ACTIVITIES	<u>\$ (4,354)</u>

ARIZONA HEALTH CARE COST CONTAINMENT SYSTEM

NOTES TO FINANCIAL STATEMENTS

Year Ended June 30, 2004
(amounts expressed in thousands)

(1) Summary of significant accounting policies

A. Reporting entity

The accounting policies of the **Arizona Health Care Cost Containment System** ("AHCCCS" or the "Agency") conform to the U.S. generally accepted accounting principles applicable to governmental units. The financial statements of AHCCCS, as a department of the State of Arizona ("State") are not intended to represent the related financial statement information of the primary government. The following is a summary of the significant accounting policies.

The Arizona Legislature established AHCCCS in November 1981 to administer health care for the State's indigent population. AHCCCS is a State agency managed by an independent cabinet level administration created by the Arizona Legislature ("Legislature"), and it is funded by a combination of federal, state and county funds. The federal portion is funded through the Centers for Medicare and Medicaid Services (CMS) of the U.S. Department of Health and Human Services under a Section 1115 waiver approved by CMS, which exempts the AHCCCS program from certain requirements of conventional Medicaid programs. This waiver has been renewed by CMS through September 30, 2006. AHCCCS receives quarterly federal grants from CMS (as matching funds) to cover a portion of the health care costs of the residents of the State eligible for the State's Title XIX Medicaid and Title XXI, State Children's Health Insurance Program (SCHIP). State appropriations and county funds are based on annual budgets as dictated by the Legislature and specified in Arizona Session Law.

AHCCCS provides acute and long-term health care coverage to eligible residents of Arizona. Eligible residents include those who qualify under Section 1931(b) of the Social Security Act, Supplemental Security Income (SSI), children who meet certain age requirements from families receiving food stamps, children and pregnant women whose household income meets eligibility requirements, certain single adults, childless couples and parents of SCHIP children under the Health Insurance Flexibility and Accountability Demonstration Initiative and uninsured women needing active treatment for breast and/or cervical cancer.

Under AHCCCS, health care coverage is provided substantially through a competitive bidding process with private and county-sponsored health plans bidding for the enrollment of AHCCCS eligibles by geographical service area. In addition, AHCCCS purchases health care services directly from providers.

Other AHCCCS lines of business include the Healthcare Group, which provides prepaid medical coverage primarily to small businesses, and the Premium Sharing Program, which provided coverage to individuals who met certain income criteria and who were not covered through other health insurance programs. The Legislature terminated the Premium Sharing Program effective September 2003. The activities of the Healthcare Group are included in the proprietary fund. The Premium Sharing Program had limited activity in fiscal year 2004 and has been included in miscellaneous funds in the current year in Note 5. See Note 6 for information on Healthcare Group.

B. Basis of presentation

The basic financial statements include both government-wide and fund financial statements. The government-wide financial statements report information on the entire Agency while the fund financial statements focus on major funds. Each presentation provides valuable information that can be analyzed and compared between years to enhance the usefulness of the information.

The government-wide financial statements (i.e., the statement of net assets and the statement of activities) report information on the entire Agency. The effect of all significant interfund activity has been removed from these financial statements.

ARIZONA HEALTH CARE COST CONTAINMENT SYSTEM

NOTES TO FINANCIAL STATEMENTS

Year Ended June 30, 2004
(amounts expressed in thousands)

(1) **Summary of significant accounting policies (continued)**

The statement of activities demonstrates the degree to which the governmental and business-type activities direct expenses are offset by program revenues. Direct expenses are those that are clearly identifiable with a specific function. Program revenues include appropriations, contributions and grants that are restricted for the operational or capital requirements of a particular function or segment.

Fund financial statements provide information about the Agency's funds. Separate financial statements are provided for the governmental and proprietary funds. The General Fund is the Agency's primary operating fund and it accounts for all financial resources except those required to be accounted for in another fund. AHCCCS has one business-type activity, Healthcare Group. In fiscal year 2004, AHCCCS did not have any major funds; accordingly, all remaining governmental funds are aggregated and reported as non-major funds.

C. Measurement focus, basis of accounting and financial statement presentation

The government-wide financial statements are reported using the economic resources measurement focus and the accrual basis of accounting, as are the proprietary fund financial statements. Revenues are recorded when earned and expenses are recorded when a liability is incurred, regardless of the timing of the related cash flows.

Proprietary funds distinguish between operating revenues and expenses from non-operating items. Operating revenues and expenses generally result from providing services and producing and delivering goods in connection with a proprietary fund's principal ongoing operations. The principal operating revenues of the Healthcare Group are premiums charged to small uninsured businesses with 1 to 50 employees and employees of political subdivisions for medical coverage. Operating expenses for the Healthcare Group include the costs of sales and services, administrative expenses, and depreciation on capital assets. All revenues and expenses not meeting this definition are reported as non-operating revenues and expenses.

Proprietary fund revenues are recognized when they are earned and expenses are recognized when they are incurred. Member premiums are due by the first day of the month preceding the month of coverage. At June 30, 2004, the proprietary fund deferred revenue balance was comprised of premium payments received for the months of July and August 2004.

The governmental fund financial statements are reported using the current financial resources measurement focus and the modified accrual basis of accounting. Revenues are recognized as soon as they are both measurable and available. Revenues are considered to be available when they are collectible within the current period or soon enough thereafter to pay liabilities of the current period. For this purpose, AHCCCS considers revenue to be available if they are collected within 31 days of the end of the current fiscal year. The governmental funds deferred revenue consists of county contributions for July 2004 deposited in advance. Expenditures generally are recorded when a liability is incurred, as under accrual accounting. Accrued programmatic costs include estimates for incurred but not reported (IBNR) claims for a 31-day period following the end of the fiscal year. Actual results for accrued programmatic costs may differ from such estimates. These differences are recorded in the period in which they are identified. However, expenditures related to capital leases, compensated absences and claims and judgments are recorded only when payment is due.

ARIZONA HEALTH CARE COST CONTAINMENT SYSTEM

NOTES TO FINANCIAL STATEMENTS

Year Ended June 30, 2004
(amounts expressed in thousands)

(1) Summary of significant accounting policies (continued)

In fiscal year 2004, AHCCCS reports the following significant funds:

- a. The general fund is AHCCCS' primary operating fund for the Title XIX Medicaid program and the Title XXI State Children's Health Insurance Program.
- b. Special revenue funds, reported as other funds, account for various health and administrative programs.
- c. The Healthcare Group fund, reported as a business-type activity, accounts for the activities of a prepaid medical coverage program primarily to small, uninsured businesses with 1 to 50 employees and employees of political subdivisions.

In fiscal 2003, the KidsCare funds were classified within Other Governmental Funds. However, in fiscal 2004, due to a change in the source of state matching funds (from the Tobacco Tax and Health Care Fund – Medically Needy Account to the State General Fund) these funds have been classified as General Funds. Because accrued expenditures are offset by corresponding federal grant and State appropriation revenues receivable in the General Fund, this change results in an adjustment to the accrued revenue source without restating net assets.

Additionally, the Tobacco Tax and Health Care Fund - Medically Needy Account was classified as a Major Fund in fiscal 2003. In fiscal 2004, this fund no longer meets the criteria to qualify as a Major Fund and is now combined into the single, aggregated presentation under Other Governmental Funds.

Private-sector standards of accounting and financial reporting issued prior to December 1, 1989, generally are followed in both the government-wide and proprietary fund financial statements to the extent that those standards do not conflict with or contradict guidance of the Governmental Accounting Standards Board. Governments also have the option of following subsequent private-sector guidance for their business-type activities and enterprise funds, subject to this same limitation. AHCCCS has elected to follow subsequent private-sector guidance.

D. Cash and investments

Substantially all of the cash and investments maintained by AHCCCS are held by the State of Arizona Office of the Treasurer ("Treasurer") with other state monies. Investment income is allocated to AHCCCS on a pro rata basis. Amounts held by the Treasurer are recorded at fair value and totaled \$92,049 at June 30, 2004 including restricted funds of \$11,281.

The State is statutorily limited (by ARS §35-312 and §35-313) to certain investment types. Additionally, State statutes require investments made to be in accordance with the "Prudent Person" rule. This rule imposes the responsibility of making investments with the judgment and care that persons of ordinary prudence would exercise in the management of their own affairs when considering both the probable safety of their capital and the probable income from that capital. The Treasurer issues a separately published Annual Financial Report that provides additional information relative to the Treasurer's total investment activities.

ARIZONA HEALTH CARE COST CONTAINMENT SYSTEM

NOTES TO FINANCIAL STATEMENTS

Year Ended June 30, 2004
(amounts expressed in thousands)

(1) Summary of significant accounting policies (continued)

Cash in the General Fund has been internally restricted by AHCCCS in the amount of \$11,107 for the Inter-Agency Service Agreement Fund (ISA). The ISA Fund is used to properly account for, control, and report receipts and disbursements associated with ISA's, which are not required to be reported in other funds. Fund receipts consist of monies received from other entities and are utilized to match federal funding under the Medicaid and SCHIP programs under the terms stated in the ISA. Cash in the Other Funds is legally restricted in the amount of \$174 for the Hawaii Arizona PMMIS Alliance (HAPA) Fund, as described in Note 5, and is offset by an equal amount of deferred revenue at June 30, 2004.

In accordance with the Federal Cash Management Improvement Act guidelines, AHCCCS may only request federal funds under specified funding techniques. These techniques require that AHCCCS draw down or request funds for any check issued in accordance with its historical average check clearance pattern. The timing difference that occurs, due to drawing down funds after the issuance of checks, may result in bank overdrafts to AHCCCS at various times during the year. At June 30, 2004, a bank overdraft of \$4,945 existed which represented the excess of checks issued over federal funds deposited.

E. Capitation payments

AHCCCS' contracted health plans receive fixed capitation payments, generally in advance, based on certain rates for each AHCCCS member enrolled with the plan. The plans are required to provide all covered health care services to their members, regardless of the cost of care. If there are funds remaining, the plan retains the funds as profit; if the costs are higher than the amount of capitation payments from AHCCCS, the plan absorbs the loss, except for those cases eligible for reinsurance payments.

Capitation is paid prospectively as well as for prior period coverage (PPC). The PPC period is from the first day of the month of application to the time of enrollment with a contracted health plan. The risk under PPC is shared by both the contracted health plans and AHCCCS for the contract year ended September 30, 2002. AHCCCS reconciles the actual PPC medical costs to the PPC capitation paid during the year. The reconciliation limits the contractor's profits and losses to 2%. Except for Title XIX waiver members, effective October 1, 2002, the PPC rates were adjusted and the reconciliation of PPC costs was not performed for the contract year ended September 30, 2003. The PPC reconciliation is reinstated for the contract year ended September 30, 2004.

Similar risk sharing is in place for medical costs incurred by contracted health plans for the Title XIX Waiver Group (TWG) members. AHCCCS reconciles the contractor's PPC and prospective medical costs to PPC capitation, prospective capitation, hospitalized supplemental payments, delivery supplemental payments and HIV/AIDS supplemental payments paid to the contractor during the year. The reconciliation limits the contractor's profits or losses to 2%. Accrued programmatic costs include approximately \$4,825 at June 30, 2004 that represents estimated settlement payments due to contracted health plans for the TWG reconciliation. Actual results may differ from this estimate and such differences will be recorded in the period in which they are identified.

F. Reinsurance payments

AHCCCS provides a stop-loss reinsurance program for its contracted health plans for partial reimbursement, after a deductible is met, of covered inpatient facility medical services incurred for members with an acute medical condition. For long-term care members, the program includes a deductible, which varies based on the health plan's member enrollment and the eligibility category of their members. For acute care members, health plans choose their deductible level for all eligibility groups. AHCCCS reimburses the health plans based on a coinsurance amount for inpatient-covered services incurred above the deductible.

ARIZONA HEALTH CARE COST CONTAINMENT SYSTEM

NOTES TO FINANCIAL STATEMENTS

Year Ended June 30, 2004
(amounts expressed in thousands)

(1) Summary of significant accounting policies (continued)

The reinsurance program also includes a special catastrophic reinsurance program which covers conditions such as certain brain injuries, certain blood related disorders or conditions resulting in covered organ transplantation. There is no deductible for catastrophic reinsurance cases and AHCCCS reimburses the health plans at a percentage of the health plans' paid amount, less the coinsurance amount, unless the costs are paid under a subcapitated arrangement. For catastrophic reinsurance, AHCCCS pays 85% of the health plans' paid amount up to \$650 and 100% thereafter. For transplants, payment is limited to 85% of the AHCCCS contract amount for the transplant services rendered or 85% of the health plans' paid amount, whichever is lower.

G. Fee-for-service payments

The AHCCCS program is responsible for the cost of providing medical services on a fee-for-service basis to three populations: persons enrolled in the Emergency Services Program (ESP), persons enrolled in a health plan for less than 30 days, and Native American members enrolled with Indian Health Services (IHS).

The ESP provides for emergency medical care to persons who are ineligible for full AHCCCS coverage due to their lack of United States citizenship or lawful alien status. Outpatient medical services for the ESP and for members enrolled in a health plan for less than 30 days are reimbursed at capped fee-for-service rates based on the category of service provided. Inpatient medical services for these populations are reimbursed based on the category of service provided and an inpatient per-diem reimbursement rate system.

Medical services provided at an IHS facility or by a tribal-owned facility licensed by IHS are reimbursed at rates determined by the Office of Management and Budget (OMB). Off-reservation services are reimbursed based on the AHCCCS inpatient and outpatient fee-for-service rates.

H. Incurred but not reported programmatic expenditures

In the accompanying financial statements, the fee-for-service and reinsurance expenditures include claims paid, claims in process and pending, and the estimate made by management for incurred but not reported (IBNR) programmatic claims. These IBNR programmatic claims include charges by physicians, hospitals and other healthcare providers for services rendered to eligible members during the period for which claims have not yet been submitted.

The estimates for IBNR programmatic claims are developed using actuarial methods based upon historical data for payment patterns and other relevant factors. Such liabilities are necessarily based on assumptions and estimates, and while management believes the amount is adequate, the ultimate liability may be in excess of or less than the amount provided. The methods for making such estimates and for establishing the resulting liability are continually reviewed, and adjustments are reflected in the period determined.

I. Disproportionate share hospital payments

CMS and the Legislature authorized AHCCCS to make disproportionate share payments to Arizona hospitals that provided care to a disproportionate share (as defined) of the State's indigent population. The Disproportionate Share Hospital (DSH) special line item appropriation received a supplemental increase of \$21.1 million. This increase was in conjunction with the Federal Medicare Modernization Act legislation that increased the federal DSH Allotment for Arizona by 16 percent. Expenditures for disproportionate share totaled \$157,940 for the year ended June 30, 2004.

ARIZONA HEALTH CARE COST CONTAINMENT SYSTEM

NOTES TO FINANCIAL STATEMENTS

Year Ended June 30, 2004
(amounts expressed in thousands)

(1) Summary of significant accounting policies (continued)

J. Taxes

AHCCCS is an agency of the state of Arizona and is not subject to income taxes.

K. Management's use of estimates

The preparation of financial statements in conformity with U.S. generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, disclosure of contingent assets and liabilities at June 30, 2004, and the reported amounts of revenues and expenditures during the fiscal year then ended. Actual results may differ from these estimates.

L. 100% federal poverty level expansion and CMS waiver

On November 7, 2000, the Arizona voters approved ballot Proposition 204. One of its primary components directed AHCCCS to increase the minimum qualifying income eligibility level up to 100% of the Federal Poverty Level. Proposition 204 also designated AHCCCS as the administrator of the tobacco litigation settlement funds awarded to the State for compensation of costs incurred in providing its citizens with health care and other services necessitated by the use of tobacco products.

AHCCCS obtained a waiver from CMS to receive federal funding for the newly eligible populations and to fund additional legislation passed during the 2001 State legislative session to implement Proposition 204. The CMS waiver requires that the newly covered population not previously categorically eligible for Medicaid be budget neutral for CMS. The waiver period for budget neutrality began April 1, 2001 and extends through federal fiscal year 2006, at which time any federal funds received by the State that exceed the negotiated budget neutrality limit must be returned to CMS. Because any future settlement amount is currently not determinable, no liability for any excess federal funds has been recorded in the accompanying financial statements. See Note 9.

AHCCCS has classified the Arizona Tobacco Litigation Settlement Fund, created by ballot Proposition 204, as part of its General Fund. These funds are restricted for use as specified in litigation settlement and/or legislation. Annual settlement payments, based on cigarette sales from the preceding calendar year are made in April. In addition, supplemental payments may be received as tobacco companies enter into the tobacco master settlement agreement. AHCCCS received \$91,625 in April 2004 and a supplemental payment of \$925 for a total of \$92,550. Revenue and a related receivable of \$44,862 was accrued for the period of January 1 through June 30, 2004 and is included in tobacco tax revenue and tobacco settlement receivable in the accompanying statement of revenues, expenditures and changes in fund balance – governmental funds.

ARIZONA HEALTH CARE COST CONTAINMENT SYSTEM

NOTES TO FINANCIAL STATEMENTS

Year Ended June 30, 2004
(amounts expressed in thousands)

(2) Capital assets

Capital assets, which consist of furniture, vehicles and equipment, are reported in the governmental and business-type activity columns in the government-wide statement of net assets. Capital assets are defined as assets with an initial, individual cost of more than \$5 and an estimated useful life in excess of one year. Such assets are recorded at historical cost and are depreciated over their useful lives ranging from three to five years. The costs of normal maintenance and repairs that do not add to the value of the asset or materially extend assets lives are not capitalized. The assets retired in the amount of \$111 in the current fiscal year were fully depreciated. Net asset balances and current fiscal year activity are as follows:

Balance, June 30, 2003	\$ 3,716
Additions	4,070
Retirements	-
Depreciation	(1,611)
Balance, June 30, 2004	<u>\$ 6,175</u>

(3) Capital leases

On June 30, 2004, AHCCCS entered into a capital lease agreement with Baystone Financial Group. Under the lease agreement, AHCCCS acquired \$3,293 of telecommunications equipment. Of this total, \$1,594 was paid in the form of a cash down payment and the remaining \$1,699 was financed. The lease agreement qualified as a capital lease for accounting purposes and, therefore, a liability in the amount of \$1,699 has been recorded in the government-wide financial statements, which represents the present value of the future minimum lease payments as of the lease inception date. The future minimum lease obligations and the net present value of the future minimum lease payments as of June 30, 2004 are as follows:

<u>Fiscal Year Ending June 30</u>	<u>Annual Debt Service Governmental Governmental Activities</u>
2005	\$ 381
2006	381
2007	381
2008	381
2009	<u>382</u>
Total future minimum lease payments	1,906
Less amount representing interest	<u>(207)</u>
Present value of future minimum lease payments	1,699
Less current portion	<u>(310)</u>
Noncurrent portion	<u>\$ 1,389</u>

(4) Compensated absences

It is the State's policy to permit employees to accumulate earned but unused vacation, compensatory and sick pay benefits. There is no liability recorded on AHCCCS' financial statements for sick leave as any amounts eligible for payment when employees separate from State service are the responsibility of the Arizona Department of Administration. The amount recorded in the government-wide financial statements consists of employees' vested accrued vacation and accrued compensatory time benefits. All compensated absences are due within one year. Balances and current fiscal year activity are as follows:

Balance, June 30, 2003	\$ 2,822
Additions	3,857
Reductions	(3,847)
Balance, June 30, 2004	<u>\$ 2,832</u>

ARIZONA HEALTH CARE COST CONTAINMENT SYSTEM

NOTES TO FINANCIAL STATEMENTS

Year Ended June 30, 2004
(amounts expressed in thousands)

(5) Other funds

At June 30, 2004, the other fund balance of \$4,369 was comprised of the following funds:

- Tobacco Tax and Health Care Fund, Medically Needy Account (TTHCF-MNA) - The Arizona Department of Revenue allocates funding to the TTHCF-MNA which provides funding for services provided through the Title XIX Medicaid and other legislatively authorized health related services or programs. Revenue sources for the TTHCF-MNA include Tobacco Tax proceeds and investment income.
- Tobacco Products Tax Fund Emergency Health Services Account (TPTF-EHSA) – The Arizona Department of Revenue allocates the tobacco tax revenue to the TPTF-EHSA which is used solely for the reimbursement of uncompensated care, primary care services and trauma centers readiness costs. Revenue sources for the TPTF-EHSA include tobacco tax proceeds and investment income.
- Third Party Liability Fund – This fund is comprised of monies recovered from first and third party payers under various AHCCCS recovery programs prior to the disbursement to the appropriate programs. These programs include casualty, special treatment trusts, estate and health insurance recoveries.
- Trauma and Emergency Services Fund – This fund is comprised of gaming revenues to be used to reimburse hospitals in Arizona for unrecovered trauma center readiness costs and unrecovered emergency services costs.
- Miscellaneous Funds – These funds account for various grants and other money received for specific purposes, and includes the Hawaii Arizona PMMIS Alliance (HAPA). HAPA represents AHCCCS' project with Hawaii whereby AHCCCS processes the claim for Hawaii's Medicaid program.

Other funds earned, expended and transferred during the fiscal year ended June 30, 2004 were as follows:

	Tobacco Tax Fund MNA	Tobacco Tax Fund- EHSA	Third Party Liability Fund	Trauma and Emergency Services Fund	Miscel- laneous Funds	Total
Fund balances, June 30, 2003	\$ 13,447	\$ 2,037	\$ 692	\$ -	\$ 2,476	\$ 18,652
Receipts	107,856	27,844	1,610	12,616	8,233	158,159
Interest earned	108	47	14	15	104	288
Expenditures	(70,025)	(3,938)	(1,039)	(15,631)	(9,584)	(100,217)
Transfers in (out):						
General Fund	(20,575)	(22,990)	-	-	32	(43,533)
Arizona Dept of Health Services	(28,100)	-	-	-	-	(28,100)
ADHS Health Crisis Fund	(880)	-	-	-	-	(880)
Other Funds	-	(3,000)	-	3,000	-	-
Fund balances, June 30, 2004	<u>\$ 1,831</u>	<u>\$ -</u>	<u>\$ 1,277</u>	<u>\$ -</u>	<u>\$ 1,261</u>	<u>\$ 4,369</u>

ARIZONA HEALTH CARE COST CONTAINMENT SYSTEM

NOTES TO FINANCIAL STATEMENTS

Year Ended June 30, 2004
(amounts expressed in thousands)

(6) Proprietary fund

The Healthcare Group was established in 1988 by the State to administer prepaid medical coverage primarily to small, uninsured businesses with 1 to 50 employees and employees of political subdivisions. Healthcare Group Administration (HCGA) contracted with two health plans from the existing network of AHCCCS health plans to enroll members and provide healthcare services. Subsequent to fiscal year-end, the network was expanded to three health plans. HCGA conducts premium billing, collections, fund disbursement and data analysis. HCGA is responsible for the regulatory oversight of the health plans.

For State fiscal year 2004, \$2.989 million was appropriated from the General Fund for Healthcare Group administrative and reinsurance costs. This allocation is included in transfers in the accompanying statement of revenues, expenses and changes in fund net assets – proprietary fund. HCGA revised its premium rates effective February 1, 2003 to fully fund reinsurance payments to the participating health plans from premium collections. These new rates are intended to eliminate the reliance on future appropriations. Current legislation only provides the appropriated subsidy funding for Healthcare Group through fiscal year 2005.

(7) Retirement plan

AHCCCS employees are covered by a defined benefit retirement plan administered by the Arizona State Retirement System Board. Benefits are established by State statute and provide retirement and long-term disability benefits to AHCCCS employees. The retirement plan is funded by payroll deductions from eligible employees' gross wages and matching amounts contributed by AHCCCS. These amounts satisfy the statutory requirement that employees and AHCCCS contributions must cover the actuarially determined current service costs of the retirement plan, plus amortization over a 30-year period of the unfunded past service liability. Payroll deductions as a percentage of employee wages were 5.2% for retirement and .5% for long-term disability for 2004. The matching amount contributed to the retirement plan by AHCCCS was \$2,431 in 2004 and is included in administrative expenditures in the accompanying government-wide and governmental fund financial statements.

Retirement benefit payments are obligations of the retirement plan and not AHCCCS. Actuarial and financial data on the retirement plan are available from the retirement plan's separately issued Comprehensive Annual Financial Report (CAFR).

(8) Budgetary basis of accounting

The financial statements of AHCCCS are prepared in conformity with U.S. generally accepted accounting principles (GAAP). AHCCCS, like all other State agencies, prepares its annual budget on a basis that differs from the GAAP basis. The State's accounting system and Arizona Revised Statutes and policies provide for an additional accounting period (13th month) to make payments for goods or services received or incurred by the end of the fiscal year and subsequently invoiced during the 13th month. The financial statements report total budget basis expenditures to include both the fiscal year and the 13th month activity. The State does not have a legally adopted budget for revenues. Prior fiscal year expenditures of \$85.202 million paid in the current fiscal year in accordance with the administrative adjustment procedures as authorized by Arizona Revised Statutes are reported as a separate amount. AHCCCS' controlling statute for program administrative adjustment procedures varies from the statutory requirement of other State agencies. AHCCCS is permitted to pay for approved system covered medical services presented after the close of the fiscal year in which they were incurred with either remaining prior year or current year available monies.

ARIZONA HEALTH CARE COST CONTAINMENT SYSTEM

NOTES TO FINANCIAL STATEMENTS

Year Ended June 30, 2004
(amounts expressed in thousands)

(8) Budgetary basis of accounting (continued)

The following is a reconciliation of the GAAP basis statement of revenues, expenditures and changes in fund balances – governmental funds to the budgetary comparison schedules for the year ended June 30, 2004:

	General Fund Actual
Budgetary basis fund balance, June 30, 2004	\$ 48,224
Basis of accounting differences:	
Increases to fund balance:	
Due from State and county governments	3,931
Due from the federal government	59,357
Due from other fund	11,416
Receivables and other	328
Total increases	75,032
Decreases to fund balance:	
Deferred revenue	(17,400)
Due to federal, State and county governments	(35,403)
Due to other funds	(300)
Accrued programmatic costs	(62,718)
Payables and other	(7,435)
Total decreases	(123,256)
Total GAAP basis fund balance	\$ -

Non-appropriated expenditures of \$1,405,533 in the general fund consist of federal pass-through payments to other agencies.

(9) Contingencies

Grant adjustment - Amounts received from CMS are subject to audit and adjustments. At June 30, 2004, AHCCCS had claimed reimbursement from CMS on its Form CMS-64 of approximately \$82.3 million representing additional reimbursement AHCCCS believes it is due for health care services provided to Native Americans off the reservation. CMS has disallowed this claim through the March 2004 quarter and AHCCCS anticipates a disallowance for the June 2004 claim. AHCCCS appealed this decision and the Department of Health and Human Services, Departmental Appeals Board upheld the disallowance. As a result, AHCCCS has not drawn down these funds from CMS nor are they included in the accompanying financial statements. AHCCCS believes reimbursement of these funds is supported in law and continues to pursue recovery of these funds through legal efforts.

Litigation and investigations - AHCCCS has been named as a defendant in a variety of litigation, all of which are being defended by legal counsel. It is the opinion of AHCCCS, upon consultation with legal counsel, that none of these claims is likely to have a material adverse effect on AHCCCS' financial statements. In addition, AHCCCS believes that the funding of any material adverse judgment, sanction or repayment obligation in excess of its appropriation would require a special appropriation by the State.

Additionally, AHCCCS has filed a lawsuit seeking recovery from the federal government for services provided to Native Americans off the reservation. In similar cases, North Dakota and South Dakota have achieved successes although their cases are presently on appeal with the Eighth Circuit Court of Appeals.

ARIZONA HEALTH CARE COST CONTAINMENT SYSTEM

NOTES TO FINANCIAL STATEMENTS

Year Ended June 30, 2004
(amounts expressed in thousands)

(9) Contingencies (continued)

Compliance with laws and regulations - AHCCCS is subject to numerous laws, regulations and oversight by the federal government. These laws and regulations include, but are not necessarily limited to, matters such as government health care program participation requirements, reimbursement for member services and Medicaid fraud and abuse. Violations of these laws and regulations could result in expulsion from government health care programs, together with the imposition of significant financial sanctions. Management believes that AHCCCS is in compliance with fraud and abuse laws and regulations, as well as other applicable government laws and regulations. Compliance with such laws and regulations can be subject to future review and interpretation as well as regulatory actions unknown at this time.

Budget neutrality agreement – In January 2001, AHCCCS obtained a Section 1115 Waiver (“Waiver”) from CMS to receive federal funding for certain non-categorically linked populations including those made eligible by the November 2000 passage of Proposition 204. The Waiver requires that over the term of the agreement (April 1, 2001 through September 30, 2006), the population covered by the Waiver be budget neutral for CMS. Under budget neutrality, CMS will not pay more for medical services with the Waiver than it would without the Waiver. The Waiver Special Terms and Conditions (STC) include a monitoring arrangement that requires AHCCCS to report the financial results of the Waiver on a quarterly basis. It also established a diminishing annual threshold of the amount by which AHCCCS is able to exceed the budget neutrality limit on an interim basis before being required to submit a corrective action plan. The reporting limit threshold for the second budget neutrality period, which ended September 30, 2003, was 3 percent. At June 30, 2004 AHCCCS is below the limit for this period by \$7.0 million (0.15 percent) on a cumulative basis. The third budget neutrality period does not end until September 30, 2004. Through June 30, 2004, AHCCCS remains under the cumulative reporting limit threshold. The budget neutrality calculation is dependent on a number of variables including the number of new Proposition 204 members, the general economy and its impact on unemployment, medical inflation and policy decisions that may impact program costs made by the Legislature. Given the uncertainty surrounding these factors, AHCCCS is not presently able to determine if the budget neutrality limit will be exceeded or if it is exceeded that CMS will require repayment of the excess. Management believes that as of June 30, 2004, AHCCCS does not have any liability related to CMS for the budget neutrality agreement. Accordingly, the accompanying basic financial statements have not been adjusted for the impact of any liability AHCCCS’ may have related to the budget neutrality agreement for Proposition 204.

Healthcare regulation - The healthcare industry is subject to numerous laws and regulations of federal, state and local governments. These laws and regulations include, but are not necessarily limited to, matters such as licensure, accreditation, government healthcare program participation requirements, reimbursement for patient services, and Medicare and Medicaid fraud and abuse. Violations of these laws and regulations could result in expulsion from government healthcare programs together with the imposition of significant fines and penalties. At June 30, 2004, AHCCCS was not a Medicare certified facility and did not derive any of its revenue from the provision of services to Medicare beneficiaries. Management believes that AHCCCS is in compliance with fraud and abuse laws and regulations, as well as other applicable government laws and regulations. Compliance with such laws and regulations can be subject to future review and interpretation as well as regulatory actions unknown or unasserted at this time.

The Health Insurance Portability and Accountability Act of 1996 (“HIPAA”) broadened the scope of certain fraud and abuse laws by adding several criminal provisions for health care fraud offenses that apply to all health benefit programs. Additionally, Federal enforcement officials now have the ability to exclude from Medicaid any investors, officers and managing employees associated with business entities that have committed health care fraud, even if the officer or managing employee had no knowledge of the fraud. HIPAA was followed by the Balanced Budget Act of 1997 (“BBA-97”), which created additional fraud and abuse provisions, including civil penalties for contracting.

ARIZONA HEALTH CARE COST CONTAINMENT SYSTEM

NOTES TO FINANCIAL STATEMENTS

Year Ended June 30, 2004
(amounts expressed in thousands)

(9) Contingencies (continued)

The Administrative Simplification Provisions of HIPAA require the use of uniform electronic data transmission standards for certain health care claims and payment transactions submitted or received electronically. These provisions are intended to encourage electronic commerce in the healthcare industry. The U.S. Department of Health and Human Services ("HHS") has issued regulations implementing the HIPAA Administrative Simplification Provisions and compliance with these regulations became mandatory for AHCCCS on October 16, 2003. AHCCCS believes that the cost of compliance with these regulations has not had and is not expected to have a material adverse effect on its business, financial position or results of operations.

HIPAA also requires the HHS to adopt standards to protect the privacy and security of individually identifiable health-related information. HHS released regulations containing privacy standards in December 2000 and published revisions to the regulations in August 2002. Compliance with these regulations became mandatory on April 14, 2003. The privacy regulations regulate the use and disclosure of individually identifiable health-related information, whether communicated electronically, on paper or orally. The regulations also provide patients with significant new rights related to understanding and controlling how their health information is used or disclosed. HHS released security regulations on February 20, 2003 with amendments on April 17, 2003. The security regulations will become mandatory on April 20, 2005 and will require health care providers to implement administrative, physical and technical practices to protect the security of individually identifiable health information that is maintained or transmitted electronically. The privacy regulations and security regulations, when fully implemented, could impose significant costs on AHCCCS in order to comply with these standards. AHCCCS believes that the cost of compliance with these regulations is not expected to have a material adverse effect on its business, financial position or results of operations.

Violations of HIPAA could result in civil penalties of up to \$25,000 per type of violation in each calendar year and criminal penalties of up to \$250,000 per violation. In addition, there are numerous legislative and regulatory initiatives at the Federal and state levels addressing patient privacy concerns. AHCCCS will continue to remain subject to any Federal or state privacy-related laws that are more restrictive than the privacy regulations issued under HIPAA. These statutes vary and could impose additional penalties.

(10) Interfund receivables, payables and transfers

Interfund activity is defined as transactions between funds administered by AHCCCS. The composition of interfund balances as of June 30, 2004 is as follows:

Receivable fund	Payable fund	Amount		
Healthcare Group	General Fund	<u>\$ 300,000</u>		
Transfers in				
	General	Other	Healthcare Group	Total
Transfers out:				
General Fund	\$ -	\$ 32	\$ 2,989	\$ 3,021
Other funds:				
Tobacco Products Tax Fund-				
Emergency Health Services Account	22,989	-	-	22,989
Tobacco Tax and Health Care Fund-				
Medically Needy Account	20,576	-	-	20,576
	<u>\$ 43,565</u>	<u>\$ 32</u>	<u>\$ 2,989</u>	<u>\$ 46,586</u>

ARIZONA HEALTH CARE COST CONTAINMENT SYSTEM

NOTES TO FINANCIAL STATEMENTS

Year Ended June 30, 2004
(amounts expressed in thousands)

(10) Interfund receivables, payables and transfers (continued)

In the government-wide statement of activities, the interfund activity has been eliminated. The total net transfers out of \$28,980 reported on the statement of activities represents transfer activities to other State agencies.

(11) Transactions with other State agencies

Transactions with other State agencies - AHCCCS contracts for administrative and programmatic services from other State agencies. Charges for administrative services are based on the performing agencies' actual cost. Charges for programmatic services are generally based on actuarially determined capitation rates. The following is a summary of contracted services provided:

Administrative services - The Arizona Department of Economic Security (ADES) charges AHCCCS to determine eligibility for certain Title XIX members. The Arizona Department of Administration charges AHCCCS for data center services, equipment costs and telephone line charges. The Arizona Department of Health Services (ADHS) charges AHCCCS for licensure, preadmission screening and resident review services and administrative costs associated with the Breast and Cervical Cancer Treatment program. The Arizona Office of Administrative Hearings charges AHCCCS for administrative hearing services. The Arizona Board of Nursing charges AHCCCS for the cost of administering the nurse aid training program for nurse assistants. These expenditures are included in administrative expenditures in the accompanying statement of revenues, expenditures and changes in fund balances - governmental fund. The following is a summary of transactions with these State agencies for the services described above for the year ended June 30, 2004.

	<u>Expenditures</u>
Arizona Department of Economic Security	\$ 77,833
Arizona Department of Administration	8,572
Arizona Department of Health Services	1,542
Arizona Board of Nursing	210
Arizona Office of Administrative Hearings	203
	<u>\$ 88,360</u>

Programmatic services - Certain health care-related programmatic services are provided by other State agencies, which include ADES and ADHS. AHCCCS receives the State and federal funds for these services and transfers them to the appropriate agencies pursuant to the terms of intergovernmental agreements. The total amount of federal funds received by AHCCCS and passed through to these agencies was \$767,216 in 2004. The total amount of State funds received by AHCCCS and passed through to these agencies was \$280,177 in 2004. The amount passed through to ADES was \$358,134 of federal funds and \$148,650 of State funds in 2004 and is classified as long-term care capitation programmatic expenditures in the accompanying governmental funds statement of revenues, expenditures and changes in fund balances. The amount passed through to ADHS was \$409,082 of federal funds and \$131,527 of State funds in 2004 and is classified as capitation-mental health services and Children's Rehabilitative Services expenditures in the accompanying statement of revenues, expenditures and changes in fund balance - governmental funds.

ARIZONA HEALTH CARE COST CONTAINMENT SYSTEM

NOTES TO FINANCIAL STATEMENTS

Year Ended June 30, 2004
(amounts expressed in thousands)

(11) Transactions with other State agencies (continued)

Revenues include \$255,108 from Arizona counties during fiscal year 2004. To the extent expenditures for long-term care services are less than county and State contributions, AHCCCS is required to remit such amounts equally to the State and the counties. At June 30, 2004, AHCCCS has accrued \$16,273, payable 50% to the State and 50% to the counties, relating to the amount that county and State contributions will exceed related expenditures. This amount is included in the due to federal, State and county governments in the accompanying balance sheet - governmental funds.

(12) Other pass through funds

Arizona school districts are eligible for federal matching funds for the administrative functions related to Early and Periodic Screening, Diagnosis and Treatment (EPSDT) outreach services at the school level. Arizona school districts are also eligible for federal matching funds on a fee-for-service basis for the provision of certain AHCCCS program services provided to eligible students. The total amount of federal funds received by AHCCCS and passed through to Arizona school districts was \$51,114 in 2004. This amount includes \$11,356 for administrative services, \$29,489 for program services, and \$10,269 for administrative costs associated with the payment of program services claims. These amounts are included within federal pass through funds in the accompanying statement of revenues, expenditures and changes in fund balances - governmental funds.

Laws 2001, Chapter 344 enacted several changes to implement Proposition 204, which includes a requirement that the State Treasurer withhold funds in fiscal 2004 from the counties' transaction privilege tax revenues to offset administrative costs incurred by ADES for eligibility determination. The amount passed through to ADES in fiscal 2004 was \$5,325.

Approximately \$38 was passed through to ADHS in connection with an agreement between ADHS and the U.S. Department of Health and Human Services.

At June 30, 2004, AHCCCS recorded total pass through revenue of \$1,104,270 and \$26,987 of administrative pass through expenditures in the accompanying statement of revenues, expenditures and changes in fund balance - governmental funds.

(13) New pronouncements

AHCCCS adopted the following pronouncement during 2004:

In April 2004, GASB issued GASB Technical Bulletin No. 2004-1, *Tobacco Settlement Recognition and Financial Reporting Entity Issues* ("Technical Bulletin"). This Technical Bulletin clarifies recognition guidance for tobacco settlement payments made to settling governments pursuant to the Master Settlement Agreement with the major tobacco companies. In 1998, the U.S. Tobacco industry reached an agreement (referred to as the Master Settlement Agreement, or MSA) with state governments releasing the tobacco companies from present and future smoking-related claims that had been, or potentially could be, filed by the state. In exchange, the tobacco companies agreed to make annual payments in perpetuity to the states, subject to certain conditions and adjustments. Under the Technical Bulletin, a settling government should recognize a receivable and revenue in the government-wide statements for these payments when that event occurs. Because annual payments are based on cigarette sales for the preceding calendar year, governments should estimate accrued payments that derive from sales from January 1 to their respective fiscal year-ends.

ARIZONA HEALTH CARE COST CONTAINMENT SYSTEM

NOTES TO FINANCIAL STATEMENTS

Year Ended June 30, 2004
(amounts expressed in thousands)

(13) New pronouncements (continued)

Under the modified accrual basis of accounting, revenue in the fund level statements should be recognized to the extent that the event occurs and resources become available. The provisions of the Technical Bulletin are effective for financial statements for periods ending after June 15, 2004 and were adopted by AHCCCS in fiscal 2004. Historically, AHCCCS has recorded the payments as they were received. AHCCCS receives the recurring payment in April of each year for sales for the period ended December 31.

As a result of the Technical Bulletin, for government-wide reporting purposes, AHCCCS has accrued \$44.8 million for the period from January 1, 2004 through June 30, 2004. However, based on the Technical Bulletin, AHCCCS will not accrue the payment in the fund financials, as the payment amounts are not deemed "available", as defined by GASB relative to the modified-accrual basis of accounting.

AHCCCS functions as a conduit entity for the State. Amounts are appropriated to AHCCCS by the State and are expended by AHCCCS for health care services. AHCCCS will utilize the additional accrued revenue to fund the estimated IBNR. See Note 1.

As a result of adopting this Technical Bulletin, there is no net effect on the net assets/fund balance of AHCCCS for the payment accrual. Similarly, there is no reconciling item related to the payment accrual between the fund financial statements fund balance and the government-wide net assets. The only impact is a change in the source of revenue used to offset or fund the IBNR.

(14) Subsequent events

Beginning in May 2004, enrollment began increasing and reversed a downward trend in which enrollment declined in six of the seven prior months. As a result, regular member months for the first three months of fiscal year 2005 are 2.8 percent above the legislative appropriated level. AHCCCS' management is currently assessing the recent upward trend for acute care caseload. Should these trends continue, AHCCCS will require a supplemental appropriation in fiscal year 2005. The accompanying basic financial statements have not been adjusted for any changes that might result from the outcome of this uncertainty.

ADDITIONAL INFORMATION

ARIZONA HEALTH CARE COST CONTAINMENT SYSTEM

SCHEDULE OF EXPENDITURES OF FEDERAL AWARDS

Year Ended June 30, 2004
(amounts expressed in thousands)

<u>Federal Grantor/Pass Through Agency</u>	<u>Federal CFDA Number</u>	<u>Expenditures</u>
U.S. Department of Health and Human Services		
Centers for Medicare and Medicaid Services		
Medicaid Program (Title XIX)	93.779	
Federal funds expended to vendors		\$ 3,583,058
Federal funds expended to subrecipients		11,356
Payment Accuracy Measurement Project		<u>142</u>
		3,594,555
Children's Health Insurance Program (Title XXI)	93.767	76,622
Health Resources and Services Administration		
State Planning Grant - Health Care Access for the Uninsured	93.256	<u>157</u>
TOTAL EXPENDITURES OF FEDERAL AWARDS		<u><u>\$ 3,671,335</u></u>



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**REPORT ON COMPLIANCE AND ON INTERNAL CONTROL OVER FINANCIAL
REPORTING BASED ON AN AUDIT OF FINANCIAL STATEMENTS PERFORMED IN
ACCORDANCE WITH GOVERNMENT AUDITING STANDARDS**

To the Director of the

**ARIZONA HEALTH CARE COST CONTAINMENT SYSTEM
(AHCCCS, an agency of the state of Arizona)**

We have audited the financial statements of the **Arizona Health Care Cost Containment System (AHCCCS, an agency of the state of Arizona)** at June 30, 2004 and for the year then ended, and have issued our report thereon dated November 12, 2004. We conducted our audit in accordance with U.S. generally accepted auditing standards and the standards applicable to financial audits contained in Government Auditing Standards issued by the Comptroller General of the United States.

Compliance

As part of obtaining reasonable assurance about whether the **Arizona Health Care Cost Containment System's** financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts and grants, noncompliance with which could have a direct and material effect on the determination of the financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit and, accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance that are required to be reported under *Government Auditing Standards*.

Internal Control Over Financial Reporting

In planning and performing our audit, we considered the **Arizona Health Care Cost Containment System's** internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide assurance on the internal control over financial reporting. Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control over financial reporting that might be material weaknesses. A material weakness is a condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. We noted no matters involving the internal control over financial reporting and its operations that we consider to be material weaknesses.

This report is intended solely for the information and use of the management of **Arizona Health Care Cost Containment System** and the state of Arizona Auditor General and is not intended to be and should not be used by anyone other than these specified parties. However, this report is a matter of public record and its distribution is not limited.

Mayer Hoffman McCann P.C.

Phoenix, Arizona
November 12, 2004